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Transforming “Factory Towns”: Lessons Learned and Best Practices from East Germany

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1 Introduction and Central Research Questions

Since 1989, the study of transformation processes of centrally planned economies has emerged as an important research topic in the social sciences. Interdisciplinary research approaches are imperative in this arena. Transformation processes are complex; social, political, and economic issues are closely intertwined. In order to generate comprehensive and useful knowledge about the determinants and dynamics of such transformation processes, researchers need to combine a variety of theoretical and methodological approaches.

The restructuring and modernization of socialist factory towns – cities that featured just one single large employer – is a prime example of the general intricacy of economic, political, and social change processes in Eastern Europe and the former Soviet Union. To a significant extent, production in these countries was organized in so-called *Kombinate* – vast integrated production conglomerates which were the principal organizational units of the socialist economy. *Kombinate* were groups of state-owned companies (*VEB*). They were either involved in the production of similar goods and services (horizontal integration). Or, each unit of the *Kombinat* produced intermediate goods and services which were then used to produce the end-product (vertical integration). *Kombinate* were not only the main employers in the socialist economy. They were also responsible for providing a wide range of local services, including energy delivery, schooling, and other social services. The collapse of a *Kombinat* automatically also meant the complete disintegration of the economic structures of a factory town, with large-scale social and political fallout for an entire region. As a result, the successful modernization and restructuring of these socialist conglomerates had a special significance for the overall transformation of formerly socialist political economies.

Factory towns all across the Comecon block shared a number of basic structural features. For example, all of them were important regional economic growth centers. Yet, at the same time, the extreme level of industrial integration made economic diversification in the surrounding region virtually impossible. In contrast to Henry Ford’s principle to divide the production process into different components (planning, organization of production, and engineering), the socialist planners aspired to create closed production cycles.¹

Factory towns in socialist economies were also plagued by a number of common problems. Various empirical studies have shown that the nature of socialist planning and economic organization almost always resulted in under-investment in productive infrastructure (fixed assets). As long as the *Kombinate* produced according to “plan” (i.e., they produced a certain level of output determined in the centrally determined economic 5-year-plan), investment in capital goods was largely ignored. As a consequence, the lack of investment in capital goods over time resulted in outmoded and increasingly inefficient production facilities. Consequently, the inter-

¹ See Röhl (2001), p. 10.

national competitiveness of the *Kombinate* deteriorated steadily. Accordingly, it was almost impossible for socialist states to sell goods on Western markets, due to deficiencies in design, usability, and quality. Inefficient production, typically oversized production facilities, as well as a very low degree of division of labor generated suboptimal economic results. The lack of investment in capital goods also meant that in some *Kombinate* up to 30 percent of the employed labor force was involved in repair work rather than production. Dated production methods completed this rather grim picture.²

The East German economy is a very helpful and instructive example for analyzing best (and worst) practices in restructuring and modernization processes of socialist factory towns more generally. Amongst the economies in Eastern Europe and the Soviet Union, East Germany was the poster child of socialist monopolization. In 1989, roughly 90 percent of the East German labor force was employed in 2,170 *Kombinate*. As a result, the principal challenge policymakers faced after 1989 was to transform these conglomerates into competitive firms fit to sustain the rough winds of the western-style market economy. For the numerous East German factory towns, this was a question not only of economic restructuring and reform – it was a question of mere survival.³

What are the lessons learned from the East German experience? What is best, what is worst practice in managing such a broad-based transformation processes? This study seeks to provide at least some preliminary answers to these questions. The study proceeds as follows. Chapter 2 discusses some of the unique features of the East German transformation process. Chapter 3 analyzes case studies of factory towns in the former GDR, and the ways in which the modernization and restructuring processes were managed. On the basis of these case studies, general propositions regarding successful transformation processes are formulated in chapter 4. Chapter 5 concludes.

The case studies and the resulting propositions demonstrate very clearly that successful transformation processes do not just require careful privatization schemes. Successful transformation processes also critically depend on supporting macroeconomic policies as well as suitable regional development strategies. Yet, before delving into further analysis, it is important to emphasize two issues: First, the transformation process in East Germany is not yet fully complete. In many cases, it is not entirely clear whether that process can be regarded as a success story, or indeed as a failure. Transformation processes are long-term in nature. And second, it is by no means clear that the East German experience should provide guidance for the transformation of other socialist economies. In fact, there are various reasons to believe that the East German experience in some of its facets presents a special case (see chapter 2 for more details on this issue). Nonetheless, learning from this experience is still helpful, and may indeed provide some useful assistance in managing such restructuring and modernization processes in other countries.

² See Deutsches Institut für Wirtschaftsforschung Berlin / Institut für Weltwirtschaft an der Universität Kiel / Institut für Wirtschaftsforschung Halle (1999) and Derlien et al. (1999), p. 5.

³ See Röhl (2001), p. 39.

2 The Economic Transformation Process in East Germany: A Unique Case?

The unexpected downfall of the socialist regime in East Germany in 1989, and the establishment of a democratically elected government soon thereafter, precipitated an exceptionally rapid process of economic transformation. In the spring of 1990, the newly elected East German government decided to reorganize the state-owned production facilities – mostly *Kombinate* – into joint-stock companies. Soon afterwards, the *Treuhandanstalt* (THA) – or Public Trust Company – was created by the government. The THA was mandated with the management of the privatization process in East Germany. It was supposed to either sell production facilities (individually or “en bloc”), or to retransfer property to former owners who were disenfranchised during the Nazi era or immediately after the end of the Second World War. The creation of the THA signifies the political will of the ruling elites in both East and West Germany to mediate and manage the economic transformation process, rather than to unleash the unfettered forces of the market in the five new *Bundesländer*.⁴

On 1 July 1990, an economic, monetary and social union between the two German states came into effect. Monetary union came as a shock to the East Germany economy. With the introduction of the D-Mark (since replaced by the Euro), old trading relations with Comecon partners immediately broke down – mainly caused by the 1:1 exchange rate and the introduction of West German pay levels to East Germany. Labor costs increased dramatically. As a result, many East German companies slid into a serious liquidity crisis in the fall of 1990. Consequently, there was immense pressure to modernize and restructure the East German economy in a very short period of time. A quick and successful privatization process was the first critical step in that process. Accordingly, the overwhelming number of East German production facilities were sold before they were modernized. This principle – privatization before restructuring and modernization – turned into a serious problem in those cases in which privatization was not accomplished within a reasonable period of time. Since there was no modernization of production facilities without privatization, such companies usually lost critical market shares. A fairly significant number of facilities never went back into production.⁵

Between 1990 and 1994, the THA privatized, municipalized, or liquidated more than 20.000 companies in East Germany. The preferred option of the THA was to identify external investors willing to take over formerly state-owned production facilities. Such *Kombinate* were reorganized as shareholder companies (AG: “Aktiengesell-

⁴ See Deutsches Institut für Wirtschaftsforschung/Institut für Weltwirtschaft (1992), p. 24, Czada (1994) and Dürnhöfer (1998), pp. 61.

⁵ See Nieters et al. (2000), Deutsches Institut für Wirtschaftsforschung / Institut für Weltwirtschaft (1992), p. 33, Deutsches Institut für Wirtschaftsforschung Berlin / Institut für Weltwirtschaft an der Universität Kiel / Institut für Wirtschaftsforschung Halle (1999) and Pohl (2002), pp. 30.

schaft”), the subaltern state-owned companies (VEB: “Volkseigene Betriebe”) as limited liability companies (GmbH: “Gesellschaft mit beschränkter Haftung”). In most cases the socialist conglomerates were broken into several smaller parts in order to accelerate the privatization process. In this fashion, the THA intended to create a network of small and medium-sized enterprises (SMEs) in East Germany. Attempts to sell *Kombinate* “en bloc” failed in the overwhelming number of cases.⁶

The prime challenge in this transformation process was to attract sufficient investment in a relatively short period of time in order to modernize production facilities. In 1988, production facilities in East Germany were on average 18 years old. In West Germany, in contrast, the average age was only eight years. Only 20 percent of the physical infrastructure (buildings, roads, etc.) was considered to be in good condition by the time West and East Germany reunified in 1990. Yet, there were also strong regional differences within East Germany. The Northern and Eastern regions of the GDR – traditionally characterized by a strong agrarian sector – were used as laboratories for socialist experiments for almost 40 years. Following common practice in the Soviet Union, the East German government decided to create new industrial centers in these regions. According to socialist logic, these industrial “islands” were to facilitate the development of close-knit economic exchange networks that would generate strong economies of scale and thereby generate considerable, economic growth. In most cases, however, the benefits from such economies of scale were tremendously overrated. Nonetheless, at least since 1966, the East Germany government systematically pursued the creation of *Kombinate* that tied together state-owned companies on a cross-regional basis. This model was applied to almost all industrial sectors.⁷

It was precisely these *Kombinate* – conglomerates that in many cases dominated the economic structures of entire cities – that had the most difficulty adjusting to the economic shock of economic, monetary and social union that came into effect on 1 July 1990. No other economy in Eastern Europe or the former Soviet Union adopted an entirely new legal and political framework over night. In that sense, the East German economy opted for a true shock therapy. Since the *Kombinate* were of tremendous significance for the economic survival of entire regions, it was absolutely crucial to develop “shock absorbers” – strategies that would on the one hand initiate and drive the necessary modernization and restructuring process, but at the same time ensure the continued existence of a productive economic infrastructure that would offer jobs for the East German working population. The next chapter will briefly illustrate four cases of factory towns in East Germany that went through such a successful transformation process – modernizing and restructuring the regional economy while offering jobs and economic predictability to East Germans.

⁶ An exception that proves the rule was the chemical plant Schwarzheide, privatized en bloc (BASF; see Nieters et al. (2000)); see also Deutsches Institut für Wirtschaftsforschung/Institut für Weltwirtschaft (1992), p. 24 and Deutsches Institut für Wirtschaftsforschung Berlin / Institut für Weltwirtschaft an der Universität Kiel / Institut für Wirtschaftsforschung Halle (1999).

⁷ See Albach (1998), pp. 12, Deutsches Institut für Wirtschaftsforschung Berlin / Institut für Weltwirtschaft an der Universität Kiel / Institut für Wirtschaftsforschung Halle (1998), Kujath (1999), pp. 15 and Röhl (2001), p. 10.

3 Factory Towns in East Germany: Five Case Studies

3.1 "Eisenhüttenkombinat Ost Eisenhüttenstadt (EKO)": Privatization through Investment

Background

The East German steel industry was of strategic significance for the GDR. In 1989, roughly 200 state-owned companies employed about 210.000 people in the steel sector. As the following discussion will further emphasize, the productivity in the steel sector was exceptionally low, in particular compared to Western competitors: One ton of crude steel produced in the GDR consumed more than 24 working hours, compared to 4.4 working hours in West Germany. After 1989, steel production in East Germany decreased dramatically. It is only since 1997 that the sector has slowly started to recover, after the process of restructuring and modernization was completed and the worldwide cyclical crisis in the steel market was over. One indicator for the improved positioning of the East German steel industry can be seen in the fact that there is relatively strong foreign demand for East German steel products. Yet, the productivity of the East German steel industry remains well below West German levels (roughly 60 percent). This is largely the result of firm size and resulting inefficiencies: East German steel producers are on average about a third smaller in size than their West German counterparts.⁸

Eisenhüttenstadt was the first "socialist city" to be created around the "Eisenhüttenkombinat Ost (EKO)," an industrial conglomerate of steel producing firms under central control and management.⁹ The city was the largest steel producer of the German Democratic Republic (GDR). The city's economy was entirely dependent on steel production, a mono-structuration unparalleled even in the socialist world. Almost 12,000 workers were allocated to EKO. The *Kombinat* processed pig iron; later a cold-rolling mill was installed for the production of flat steel. Yet, a full integration of all production stages was never accomplished. The central missing element was a hot-rolling mill. This production step was "outsourced" to the Soviet Union, and later to West German companies. This "steel tourism" is one of the principal reasons why the East German steel industry never reached the productivity levels of their West German counterparts.¹⁰ EKO remained dependent on imports of intermediate products throughout its existence. However, this dependency was not

⁸ See Beer (2001), p. 24 and Kohler (1994) pp. 61.

⁹ On the following see mainly Kohler (1994), pp. 61 and Dr. C. Schwartau, (former responsible for industrial consulting and support, ministry of economics of the federal state of Brandenburg), personal Interview.

¹⁰ Experts called EKO a "central tourism office for semi-finished products"; see Schuenke (1993), p. 120 and Roesler (1997), pp. 155.

entirely uncommon in the "coordinated production framework" of the Comecon system.¹¹

Deconcentration

Obviously, this industrial structure presented a major obstacle for EKO to compete effectively in world markets. As a result of the specific technical configuration of its fabrication methods, the internal organization of its management systems, and the general decentralized nature of production, EKO could never be considered a fully integrated steel producer. After 1989, there were serious discussions about closing the production facilities entirely. It is due to the persistence of EKO's management and its employees that genuine efforts were made to save at least part of the *Kombinat*. Early on in that process, however, it seemed almost impossible to identify a suitable and sufficiently potent investor.

After the creation of a shareholder company in 1990, the modernization of production facilities was started – under the leadership of EKO's old management. In order to create a viable steel production facility, investment in a hot-rolling mill was essential and recognized by all parties involved. Consequently, the government decided to provide public subsidies and loan guarantees in order to ensure the construction of a hot-rolling mill; yet, an important precondition for this public engagement was a matching commitment by a private investor. In 1994, such a private investor (Cockerill-Sambre-Group, since 2001 part of the Arcenor-Group) was found.

In 1997, the new hot-rolling mill entered production. Today it is one of the most modern installations in Europe. Between 1989 and 1997, those few parts of the EKO-*Kombinat* that were able to compete in world markets were disinvested. They initially remained integrated in the steel production process of the original EKO-*Kombinat*. However, EKO management scaled down its demand so that these newly independent companies had to open up new markets and find new customers. At the same time, EKO's core business was entirely oriented towards the market. Sales became the utmost priority.

This disinvestments process resulted in the creation of 35 new companies within five years. Today, the EKO example serves as a poster child of successful deconcentration and market reform. EKO was able to maintain about two thirds of pre-1989 employment levels, a truly astonishing number given East Germany's overall rocky road to market capitalism.

Success Factors

As a result of this phased privatization process, the old EKO management temporary remained at the helm of the company. Their goal naturally was to avoid the closing of EKO (the infamous "Abwicklung"). EKO management was supported not only by all employees, but all other local actors (supplier companies, local and regional policymakers, business associations, etc.) that were hugely dependent on

¹¹ See Beer (2001), p. 24 and Kohler (1994), p. 61.

EKO as an economic factor in the region. This alliance of management, employees, and the public at large managed to put sufficient pressure on policymakers and the THA to make a serious effort to save EKO. As a result of the early modernization and restructuring efforts that were led by the old EKO management and supported by the federal government, the private investor did not have to start from scratch. In 1994, the decentralization process was already well underway, and EKO had now access to a steadily increasing range of suppliers and service providers that had at least some experience operating in a market context.

3.2 Bitterfeld-Wolfen / Buna / Leuna: A Joint Masterplan for the “Chemical Triangle”

Background

The chemical industry (similar to the steel industry described in the previous case study) played a strategic role in the East German economy. In 1988, the chemical industry generated more than 19 percent of industrial output. During the transformation process, however, this sector quickly turned out to be the most difficult reform candidate. Even after more than six years of modernization and restructuring, the industry still suffered from steadily declining revenue levels. It is only since 1997 – after the successful restructuring and modernization of the “Chemical Triangle” – that the East German chemical industry shows signs of revitalization and healthy development. Today, it appears safe to argue that the East German chemical industry is a modern and competitive player on world markets. Between 1989 and 2000, roughly 23 billion D-Mark (approximately 11.5 billion euros) were allocated to the chemical industry. This makes a stunning 700.000 D-Mark (or 350.00 euros) for each employee employed in the industry. This is by far the largest sum of money that any East German sector managed to claim from the public sector. Current productivity hovers around 86 percent of West German levels. Similar to the steel case, this divergence in productivity levels can be explained by firm size. East German chemical companies employ roughly half the number of employees compared to their West German counterparts.¹²

It was the declared goal of the THA to save at least the main components of the East German chemical industry, primarily because of its strategic significance for the rapidly collapsing labor market. The number of people employed in the chemical industry in East Germany declined from 180.000 in 1989 to around 32,000 in 1997. However, these numbers may be misleading since they include lost jobs in areas not directly linked to the production of chemical goods. As a result, it seems more appropriate to say that the number of employees in the East German chemical industry was reduced by 93.000 between 1989 and 1997.¹³

¹² See Derlien et al. (1999), p. 4 and Beer (2001), p. 15.

¹³ See Derlien et al. (1999), pp. 6.

In the late 1980s, the state-owned companies in the “Chemical Triangle” produced roughly 50 percent of all chemical goods in East Germany. That constituted almost 10 percent of the entire industrial output of the GDR.¹⁴ Almost 50 percent of all workers living in the “Chemical Triangle” were employed by chemical production facilities. Bitterfeld was popularly labeled the “pharmacy of the Comecon”.¹⁵

The initial starting position for the chemical industry after 1989 seemed so hopeless that a continuation of production appeared unlikely, if not impossible. The “Chemical Triangle” was a symbol not just for economic inefficiency. In addition, chemicals production in East Germany left behind a large number of ecological disaster areas. The production facilities were old: A third of all facilities were older than 50 years! As a result, production techniques were antiquated compared to Western standards. Repair services tied down roughly 30 percent of all employees.¹⁶

Deconcentration

As a result of the dreadful condition of production facilities, as well as the great heterogeneity of production locations, the THA was unable to attract a single investor for the entire “Chemical Triangle”. It was soon recognized that the key for successful privatization was the creation of a viable and competitive common infrastructure. As a result, until 1997, the THA tried to sell off the main components of the “Chemical Triangle” separately – with little success. As a result, the THA reintegrated the two main production facilities under a single corporate roof, creating the holding Bitterfeld-Wolfen GmbH (privatized in 1998).

Over the course of this privatization process, only few core business streams in the “Chemical Triangle” were preserved (e.g., chlorine production in Bitterfeld). In Wolfen, for example, managers and the THA were unable to maintain the main production line (photo films). As a result, management was challenged to attract new investors. In Leuna, the refinery was quickly identified as a core element for a new development strategy, and was subsequently sold to a multinational company. The decision of this multinational to invest in Leuna attracted a broad range of other chemical and energy companies to the area, effectively creating a new industrial cluster. In Buna and Schkopau, the formerly state-owned plastic production facilities were privatized and successfully linked to regional suppliers. In 1994, another multinational company (Dow Chemical Company) decided to invest in this production location.

Today, the companies located in the Bitterfeld-Wolfen area are concentrating on chlorine production. Between 1990 and 1998, 130 companies were privatized. 67 of these companies were privatized as management buy-outs (MBO) or management buy-ins (MBI). 233 new companies invested in the area, 13 of which are firms that specialize in chemicals production. Together, these companies offer more than 10.000 jobs. As a result, the unemployment rate in Bitterfeld is lower than the regional average. In Leuna, managers and investors were able to maintain the

¹⁴ On the following see mainly Derlien et al. (1999).

¹⁵ Fischer (1993), p. 231.

¹⁶ International benchmark figure: maximum 10 percent; see Derlien et al. (1999), p. 5.

traditional concentration on oil processing: Currently, 150 firms offer more than 10.000 jobs (1989: 27.000). The "Mitteldeutsche Erdöl-Raffinerie GmbH (Mider)" alone generates roughly 3.4 percent of gross national product in the federal state of Saxony-Anhaltina. The multinational company invested 5.1 billion D-Mark and offers more than 3.000 jobs. In Leuna, most companies concentrate on plastics production, offering roughly 3.000 jobs; suppliers employ another 500 people.¹⁷

The decision to facilitate the creation of a cluster of companies concentrating on chemicals products was not the preferred choice of the THA. It was only after attempts to privatize the old state-owned conglomerate failed that THA managers turned to the cluster idea. The cluster concept for the "Chemical Triangle" contained all the typical steps (privatization of core business activities; privatization along the value-chain; modernization of particularly critical and/or complex production facilities; and attraction of new investors). However, it was critical for the eventual success of the process that the THA recognized the close network structure between the various production locations in the triangle.¹⁸ The Wolfen example illustrates the danger of domino effects in case parts of such a cluster strategy fail: In case the privatization and modernization of some components fails, this can have potentially serious negative external effects for other production locations in the cluster. Yet, the cluster concept facilitated a business- and market-oriented privatization without destroying the value of the overall infrastructure (external economies of scale). The holding company that runs the Chemical Park facilitates the coordination of the individual businesses situated in the Park. The company also offers conflict mediation services.¹⁹

Success Factors

Despite its rather late start, the "Chemical Triangle" is now widely considered to be an example of successful deconcentration and privatization. The cluster solution (i.e., the integrated development of the entire "Chemical Triangle") was the only sensible solution to this challenge due to the strong technical and economic interdependencies of the industry. Critical success factors included the development of a coherent masterplan for the development of the cluster; the maintenance and further development of a highly skilled labor force in the area; and the wide acceptance of chemical production facilities by the local population. Of particular relevance was the recognition that the improvement and development of the industrial infrastructure was key. What is still missing are sufficient applied research and development facilities that could ensure a sustainable expansion and improvement of production facilities in the cluster.

It is interesting to note that this transformation was successful, despite the fact that the geographical conditions are not altogether favorable (no access to the Baltic or North Sea). The development of a proper infrastructure (pre-production pipeline

¹⁷ See Derlien et al. (1999), pp. 17, Semkat (05.01.1996) and Müller (31.10.2000).

¹⁸ Small **meshed** group structures and closed production cycles are typical for this industry, because the transport or storage of chemical products is always problematic. Numerous by-products are to be processed. See Nieters et al. (2000) and Derlien et al. (1999), p. 8, p. 25.

¹⁹ See Derlien et al. (1999), p. 8, pp. 16 and Nieters et al. (2000).

Rostock-Böhlen; good traffic infrastructure including highways, railway, and river waterways) was obviously sufficient to compensate for this structural disadvantage.²⁰ It is also interesting to note that West German firms started to copy the cluster concept in the late 1990s. However, it is also crucial to recognize that this transformation process could only be successful because of the strong financial support of the government.

3.3 Niederlausitz (Textiles): "Destitute region" With a Future?

Background

The textiles industry has lost tremendously in significance for the East German economy. Even though the top East German leadership did not pay much attention to this part of the country's industrial infrastructure, there can be no doubt that textiles production was a very significant part of the socialist economy, in particular for less developed regions such as the Niederlausitz. Considering the fact that the textiles sectors has seen significant decline in almost all OECD-countries over the past three decades, it should not come as a surprise that the East German textiles industry was almost entirely eliminated after 1989. In 2000, this sector employed merely 22,500 people in all of East Germany – a drop of a whopping 90 percent since 1989. Currently, however, this sector exhibits a strong expansion of production and success in sales all over the world. This demonstrates the success of the restructuring process, particularly in light of strong competition from low-wage countries such as for example China or Vietnam. Until 2000, 3 billion D-mark were invested. Current productivity levels in the East German textiles industry are about 70 percent of those in West Germany. Here, again, the average firm size is the main explanatory variable. Low profit margins prohibit firms to strengthen their capital base. As a result, follow-up investment is all but secure.²¹

The Niederlausitz region, situated close to the Polish border, has a long tradition in textiles production.²² Yet, until 1989, coal and steel production were developed as the priority sectors in the region. Also, other textiles production centers in East Germany were better known and economically more significant than the Niederlausitz (e.g., Saxony, Thuringia). Still, the region featured a clear concentration in textiles production. After 1989, the Niederlausitz developed into one of East Germany's main crisis regions: The focus on declining industries (coal, steel, textiles) as well as the peripheral location at the eastern fringes of Germany made it difficult for the region to modernize, restructure, and attract new investors.

²⁰ Dow Chemical's first reaction: „ We don't like things that aren't on deep water...“; see Derlien et al. (1999), pp. 36.

²¹ See Beer (2001), p. 45.

²² On the following see mainly Thomas (2002).

Deconcentration

Already in the 1950s (!), textile production facilities in the Niederlausitz were considered outdated. Between then and the reunification, there was almost no significant investment in capital goods. Production techniques and machines were hopelessly archaic, resulting in a high cost structure and low quality output. After 1989, the THA considered investment in textiles production in East Germany as economically senseless; there was wide agreement that there could be no cost competitive textiles production in Germany. As a result, attempts to privatize the industry were only a very low priority. There were only very few privatization schemes that brought in investors from West Germany or abroad, most of which failed after only a few years. Potential strategic partners from West Germany did not show much interest to build productive capacity in East Germany. It certainly did not help that the industry did not have a strong lobby in the THA and the government. The number of employees in the textiles sector contracted between 1989 and 1993 from 11,300 to 1,400; the number of companies dropped from 51 to 20. Prospects for the remaining firms appeared bleak, to say the least.

This disintegration of the textiles industry was not met with much opposition from employees and the broader public. It is only since 1993 that the strategic significance of the textiles industry for the Niederlausitz has started to reappear as an important economic policy issue in the regional press and public policy discussions. The textiles industry has been rediscovered as a crucial component of the region's traditional identity. This became obvious, for example, during the recent "*Bundesgartenschau*" (a publicly sponsored garden and architecture show) in Cottbus that featured a textiles symposium and a fair for regional fashion.

But the Niederlausitz has moved far beyond such symbolic acts. Various entrepreneurs started to re-launch textiles production in the region, initially without any support of the skeptical THA. The citizens of the Niederlausitz and the innovation initiatives joined forces to create a common alliance against the THA that refused to provide support. A few regional policy entrepreneurs also started recognize the potential of this self-driven entrepreneurial process and decided to support new textiles companies in the region. Today, the textiles industry employs roughly 1,500 people in the region. So far, there is nothing to suggest that these companies will not be able to compete successfully in the well into the future.

Success Factors

This comparatively small example demonstrates, if anything, one important fact: Frustration can, under certain circumstances, generate not just negative, but also significant positive energy. The local population in the Niederlausitz largely considered itself as the "losers" of German reunification. The frustration reached a point where people in the region felt the only way forward was to take matters into their own hands. A critical stage was reached when an external investor failed to live up to his earlier promises, due to a combination of unprofessional behavior and bad economic planning. The long tradition of the region in producing textiles products for domestic and export markets was another critical factor for success. Nobody in the region expected any significant help from the outside; investors avoided the Niederlausitz, and the government as well as the THA did not have any viable concepts for the region's economic development. As a result, people decided to go back to the old traditions of the region – against expert advice but still successful.

3.4 "Schwermaschinenbau-Kombinat Magdeburg (SKET)": Stony Path Towards Capitalism

Background

Machine construction was the most significant industrial sector in the East German economy, with more than 540.000 workers employed in more than 600 state-owned companies. After reunification, the machine industry all but collapsed: The necessity to restructure and modernize in order to generate improved competitive, coupled with a deep cyclical crisis that shook the global machine tool industry from 1992 to 1994, put the East German producers under enormous pressure. As a result, the THA was unable to identify potent investors. Since 1995, the market has seen some improvement. Until 2000 almost 12.5 billion D-Mark were invested. Still, capital investment per workplace remains roughly 20 percent below West German levels. In contrast to most other industrial sectors, the machine tool industry has never regained pre-1991 production levels. Productivity also remains at 70 to 75 percent of West German levels. As in all other cases, the reason for this productivity gap can be explained with the comparatively small firm size in East Germany (the average firm in East Germany is only half as big as the average firm in West German), as well as the difficult market situation that has a negative impact on firm capitalization.²³

Magdeburg, today the capital of the federal state of Saxony-Anhaltina, was regarded as the GDR's heavy machine tool hub. The *SKET Kombinat* manufactured complete production facilities and exported those into the entire world. It functioned as a general contractor for hot-rolling mills and metal production facilities. In 1989, the 18 individual components of the *Kombinat* employed more than 30.000 people. 80 percent of the entire production were destined for export markets.²⁴

Deconcentration

An early plan for the restructuring and modernization of SKET foresaw the preservation of the core competencies of the old *Kombinat* as part of a single corporate structure in order to uphold existing customer relations. That plan was also designed to ensure the continued ability to export the entire assortment of products. The THA, the owner of SKET, fully supported these plans. Existing contracts seemed to justify this initial optimism right after reunification. As a result, SKET opened foreign offices and promoted cooperation agreements with a wide range of international companies. Yet, the initial positive start soon deteriorated into a debacle as markets in Eastern Europe and the former Soviet Union collapsed. The attempt to use barter contracts to maintain export markets utterly failed. The widely anticipated investment boom in the domestic machine tool market never materialized. An attempt to privatize SKET "en bloc" with the help of a strategic investor, launched in early 1996, failed as well. During this phase, the THA expected less

²³ See Beer (2001), p. 13.

²⁴ See Semkat (05.01.1996) and Ladwig (1993), pp. 271.

than 1,000 employees to remain in the *SKET Kombinat*; at a later point, these projections were further lowered to 540.²⁵

At the end of 1996, against the declared intentions of the German government (and particularly against the wishes of then-chancellor Helmut Kohl), the deconcentration process of SKET commenced. Prior to that, there was simply no consensus on how to proceed. Consequently, the privatization process ensued in a very conflictual fashion. As the deconcentration process unfolded, however, all companies of the former *SKET Kombinat* were able to expand their markets and product ranges. For example, one of these companies now produces wind energy equipment and exports its products nationwide. Other follower companies produce oil seed technology or stranding machines. The last part of SKET that was privatized now offers hot and cold-rolling technology and engineering services. The privatization of SKET was supported with 1,3 billion D-mark in public subsidies.²⁶

While SKET employed in the core business area more than 10,000 people in 1990, the follower companies provide work opportunities for only 2,000 men and women in Saxony-Anhaltina. Yet, despite this tremendous loss of jobs, the privatization process still has to be viewed as a qualified success. Most observers expected a collapse of the entire industry.²⁷

Success factors

Initial attempts to maintain and expand traditional export markets in the former Comecon countries in order to facilitate and smooth the restructuring and modernization process failed. The other attempt to transform the *Kombinat* – “en bloc” privatization – did not produce results either. It took the central actors (SKET’s management, the THA, the German government as well as potential investors) a considerable period of time to recognize that market oriented deconcentration was the only viable option. The SKET follower companies appear to be comparatively stable and well positioned in the market.

²⁵ See Ladwig (1993), pp. 273 and Semkat (12.01.1996)

²⁶ See Die Welt (16.10.1996) and Semkat (25.09.1998).

²⁷ See Semkat (05.01.1996), Ladwig (1993), p. 272 and Semkat (12.01.1996)

3.5 “Rohrkombinat Riesa” (Steel- and Rolling Mill): Successful Dissolution of a *Kombinat*

Background²⁸

Riesa – a major steel production location in the GDR – is strategically located at the periphery of the triangle Leipzig – Dresden – Chemnitz.²⁹ Until 1989, more than 20.000 employees worked in the 10 industrial production facilities in the city.

Riesa has a long tradition in steel production, going all the way back to the 1840s. After the Second World War, steel production facilities were reconstructed and reorganized as the “VEB Stahl- und Walzwerk”, a state-owned conglomerate. In 1969, that conglomerate became the core component of a *Kombinat* specializing on tube production, with main branch plants in Riesa, Freital and Görlitz. In terms of total employment, the facility in Riesa employed roughly 12,000 workers. As was common in the GDR, the *Kombinat* also provided a wide range of social services (sports facilities, the arts and theater, as well as daycare for children).

Deconcentration

The disastrous competitive situation of East German steel producers after 1989 led to a strong reduction in output within a matter of months after the economic, monetary and social union in July 1990. A worldwide crisis in steel markets and the loss of export markets in Eastern Europe further contributed to the problem. An analysis of Riesa’s productive capacity in 1990 identified outdated and oversized production facilities, as well as over-employment and extreme maintenance costs (30 percent of all employees were working in machine maintenance and repair) as the main reasons for the competitive disadvantage of Riesa steel. Incompatible production machines as well as an inefficient organization of transport between the various production locations contributed their fair share to the situation. As a result, most observers agreed that a modernization of production facilities did not make much sense from an economic perspective. The fact that the VEB was also responsible for a wide range of other products and services in the region – the construction of apartments for workers and energy supply – made the modernization and restructuring task even more difficult.

As a result of a major steel crisis in the early 1980s, the West German steel producers had just modernized their production facilities from the ground up. Therefore, from an international perspective, their productivity levels were relatively high. For that reason, West German companies showed very little interest in investing in existing steel plants in the new *Bundesländer*. In 1990, the *Kombinat* was reorganized as Stahlwerke Riesa AG (SWR AG). As a result of a lack of potential investors, the new management of SWR AG started to develop its own business and development plan. The goal was to privatize all parts of the SWR AG. As part of

²⁸ For a description and analysis of the sector’s development and current status see section 3.1.

²⁹ On the following see mainly Rehse (1996).

this new strategy, all competitive segments of the SWR AG had to be privatized until 1993. The remainder was to be closed down. The plan also foresaw that all unnecessary real estate be sold until 1995 (e.g., vacation resorts traditionally maintained by state-owned companies in the GDR). The new management also sought to attract other companies to the region, and to tear down all unnecessary production facilities. This modernization and restructuring effort necessarily resulted into a huge loss of jobs. The new business plan included certain social provisions to moderate the strong negative effects, and also included new measures to further educate the remaining workforce.

In 1995, there existed almost 70 companies operating at the old VEB production sites. These companies employed more than 4.000 people. 56 percent of new companies that were created between 1989 and 1995 were founded by local entrepreneurs. 265 of the new companies came from West Germany, 11 percent from abroad. Most companies (88 percent) have less than 50 employees. Only 9 percent employ more than 100 workers.

This modernization and restructuring process and the resulting creation of a modern industrial park turned out to be an expensive undertaking: More than 91,700 euros were invested per newly created workplace. 44 percent of these costs were covered by the THA, the federal employment agency ("Bundesanstalt für Arbeit"), and the SWR AG. The SWR AG was liquidated in due course. Today, Riesa's economy is still characterized by the steel industry. 63 percent of the employed workforce receives paychecks from steel companies.

Success Factors

In Riesa, all stakeholders decided to work together: Employees, trade unions, local and regional governments, ministries and the THA – despite a massive loss of jobs and the corresponding social frictions that ensued. The employees did not only trust their new management, they also demonstrated significant willingness to help close the productivity gap to their West German neighbors. Active labor market policy contributed to a slight amelioration of the significant negative consequences of job losses. A comprehensive and objective market analysis was critical for the design of the successful restructuring plan.

4 Successful Transformation of Socialist Factory Towns: Some Propositions

As was noted at the outset of this study, the lessons learned from the East German experience may only be of limited value for economic policymakers and investors in the other transformation economies in Eastern Europe and the former Soviet Union. Nonetheless, various "best practices" are without doubt relevant for other countries. The following sections formulate a number of such best practices in the form of propositions.

4.1 The Restructuring of Centralized Production: Nine Propositions

As noted above, the economic framework conditions in East Germany changed radically over night. The introduction of the D-Mark and the adoption of the West German legal market framework exerted enormous pressure on East German companies to become more competitive in a short period of time. Quick and successful modernization and restructuring became critical preconditions for survival. As was noted at the outset, the modernization and restructuring of a formerly state-owned company is a complex process that is very much dependent on specific framework conditions – political as well as economic. Yet, based on the case studies analyzed in the previous section, we can formulate a number of propositions regarding factors that positively contribute to transformation.

Proposition 1 Clearly define core business areas.

The precise and proper definition of core business areas of a transforming company is crucial for the further successful development and implementation of the modernization and restructuring process. In addition to identifying main business areas and core separable performance units, it is also worthwhile to consider the relevance of cross-sectional performance units. Such units either have to be newly created or have to be brought in (purchased) from the outside. It is of crucial importance to define a clear market niche within which the company can be successful. External feasibility studies can play a helpful role in this context. It is also essential to recognize the necessity of building new corporate structures to advance the modernization process. As a result of the deconcentration process of a *Kombinat*, new tasks such as procurement, distribution, or marketing have to be developed and integrated into corporate management.³⁰

³⁰ See Albach (1993), pp. 10.

Proposition 2 A critical precondition for successful transformation is cost transparency.

A critical precondition for a successful deconcentration process is comprehensive and precise knowledge about the resulting costs in each unit. The establishment of a cost ratio system facilitates access to detailed information about cost categories, cost intensity per employee, cost intensity per product, etc. This is particularly relevant for an external comparison of cost structures and efficiency. With the assistance of such a costing system, the deconcentration process can be initiated through appropriate budgeting. This also includes a realistic, market-based valuation of company assets and capacities.³¹

Proposition 3 It is difficult if not impossible to determine the net value of a company during a transformation process.

In most cases, the net value of fixed assets of a company deteriorates dramatically during a transformation process since the "hardware" does no longer suit the overall framework conditions.³² When assessing the net value of fixed assets of a company, it is important to recognize that the predominant methods for the evaluation of the capital value (net present value analysis)³³ and the substantive value (net asset valuation method, property valuation method)³⁴ are only applicable to a limited extent: It is impossible to quantify various critical elements under the specific circumstances of a reconstruction process. The concept of valuating networks, in contrast, integrates factors such as stability, diversity, volume etc. and therefore offers a useful complementary approach to assessing net value levels.³⁵ Still, even this approach can only offer a partial assessment of the economic position of a company during a fundamental transformation process. Numbers will necessarily remain incomplete.

Proposition 4 It is crucial to determine the actual level of risk.

The valuation tool described above provides a first informed impression regarding the current level of economic risk and exposure a company faces. For example, a cost ratio system allows management to determine whether a company is over-indebted. If that is the case, it is essential to determine whether the short-term viability of the company can be ensured by further deconcentration, creditor negotiations, etc. The cost ratio will also show whether or not a company faces an imminent liquidity crisis. If that is the case, it is essential to determine whether there

³¹ Substantial distortions in the reporting are typical for socialist economies, caused by immanent incentives for incomplete, inaccurate or wrong figures. See Schweickart (1997), p. 8.

³² See Albach (1998), p. 32 and Deutsches Institut für Wirtschaftsforschung Berlin / Institut für Weltwirtschaft an der Universität Kiel / Institut für Wirtschaftsforschung Halle (1998).

³³ Totaling of the bar values / deposit values on the current time; see Albach (1993), p. 68.

³⁴ This method defines the replacement value of assets and liabilities as the minimum net present value. See Albach (1993), p. 68.

³⁵ See Albach (1993), p. 76.

are ways to bridge the liquidity crisis through short-term cash credits from banks or guarantees from the government. In this context, it is important to identify the "crisis units" within the company, i.e. those parts of the corporate structure primarily responsible for the predicament.³⁶

Proposition 5 A restructuring concept creates an atmosphere of dependability and allows regular progress reviews.

The steps listed in the first two propositions are part of a systematic analysis of the company status quo. Based on that analysis, a proper restructuring concept needs to be developed before further (potentially irreversible) actions are taken. The restructuring concept may be revised and updated as the process goes along. However, the main elements and goals of the transformation process need to be clearly spelled out right from the start. The first crucial feature of a restructuring concept is the systematic analysis and discussion of all possible action scenarios. Furthermore, a restructuring concept needs to clearly describe next steps and milestones along the way – to create trust among all those involved, including the employees. Transparency is crucial in this context. All the case studies discussed in the previous section have demonstrated the importance of the commitment of employees to the success of company transformation process. In some cases, it was due to the persistence of employees (and their effective and close cooperation with company management) that a successful restructuring process was initiated and implemented, despite the lack of support from the government and/or private investors.³⁷ The development of a restructuring concept is also an indispensable tool for the constructive engagement of third parties (government, private banks, creditors, potential investors, etc.) into the overall modernization and restructuring process.

Proposition 6 It is important to identify and secure know-how present within the company.

A significant part of industrial-technical know-how is independent of economic framework conditions and remains crucially important for the company itself. Yet, the necessary knowledge with regard to legal and organizational issues will probably change radically during the transformation. In these cases, companies should be prepared to qualify their employees.³⁸

During economic crises, companies have two options with regard to personnel management: They can either try to motivate their employees, or they can attempt to cut short-term personnel-related costs. Most companies usually use a combination of both strategies, which can be problematic. The case studies presented above have demonstrated the importance of employee motivation as a crucial

³⁶ See Dürnhöfer (1998), pp. 104.

³⁷ See Dürnhöfer (1998), p. 201.

³⁸ See Albach (1993), p. 9 and p. 15 and Albach (1994), p. 35.

success factor during the transformation process. Yet, betrayed expectations can also generate the opposite result. In case the company is already in the full grip of a crisis, layoffs are usually unavoidable, since personnel costs are the most significant cost factor (as was noted above, fixed assets rapidly lose their value during the process). Depending on the legal framework conditions, layoffs can become effective fairly quickly. However, while layoffs may improve the economic situation of a company in the short-term, it also results in a loss of potentially important human capital. As a result, companies usually prefer to progress along the following steps: First, companies will cut down on overtime, and will also stop hiring new employees. In a second step, the company will use cost efficient methods to cut down the number of employees (e.g., early retirement schemes). Finally, company management will layoff non-essential personnel, primarily those working in the administrative units of the company. Management usually tries to keep essential staff members that are crucial for the successful operation of the company. However, it is precisely those employees who are the most mobile and therefore the most willing to leave.³⁹

Proposition 7 Promote market-relevant know-how.

Entrepreneurial knowledge is crucial for a company operating in a competitive market economy. The experiences in East Germany demonstrate that crucial business management knowledge was missing on all levels in more than 90 percent of all cases.⁴⁰ Here it is crucial to differentiate between explicit knowledge (can be procured through licenses or management consultants) and implicit knowledge about company specific business methods, trust relationships with suppliers, etc. Implicit knowledge is difficult to create, and requires long-term experiences and investments. Standard know-how is usually insufficient to be successful in the marketplace. When companies face entirely new framework conditions, implicit knowledge needs to be nurtured and facilitated as part of a long-term development process. Of course, a complete package of both explicit and implicit knowledge can be "procured" through the sale of the company to a market-savvy and experienced firm. Yet, in case such an external investor is not found, the company will face a wide range of problems in acquiring this crucial "knowledge package" in an adequate period of time (this is especially true in the case of management buy-outs). This applies particularly to company management, that may have only very little time during the restructuring process to acquire the necessary knowledge and expertise.⁴¹

³⁹ See Dürnhöfer (1998), p. 178.

⁴⁰ See Albach (1993), p. 9. and p. 15 and Albach (1994), p. 35.

⁴¹ See Albach (1998), p. 19 and Burchert (1996), p. 31.

Proposition 8 Distribution systems should be maintained; the quality of suppliers should be evaluated.

A lack of adequate liquidity is a trademark of almost all companies that go through a transformation process. For this reason, it is crucial to maintain and cultivate established distribution systems. In many cases this means that product sales have to move to the center of company activities in order to avoid the serious consequences of a liquidity crisis. In centrally planned economies, such a focus on sales was rather unusual (if not unheard of).⁴² It is important to recognize in this context, however, that customers may no longer accept the same level of quality. This applies in particular in those cases in which external competitors are able to quickly enter the market. The quality of intermediate products should be critically evaluated in this context. As a result, it may become necessary to develop a new network of suppliers.⁴³

Proposition 9 The deconcentration process needs to progress quickly. Yet, speed should not come at the expense of good planning.

The East German experience demonstrates that privatization "en bloc" is almost impossible to implement in practice – despite the fact that West Germany leveraged substantial financial and other resources to bankroll such an exercise. A sustainable and effective restructuring process can only be implemented on the basis of a coherent deconcentration concept. There can be no doubt that the specific form of the deconcentration process has a significant influence on the future success of individual companies that emerge from that process. The common path of deconcentration proceeds along the value chain. Each individual company needs to be able to produce competitive goods and/or services for the marketplace in an autonomous fashion. This horizontal form of deconcentration maintains supplier relationships and, as a result, allows companies to secure established production chains at least for some period of time. The smaller the specificity of individual products, the higher the probability that the newly created companies will develop new supplier and distribution systems over time. The probability of company survival increases with the number of potential buyers and suppliers. These facilitate a lower dependency on the original network of suppliers and buyers developed as part of the *Kombinat*. At the same time, all individual units of the former conglomerate remain in existence, and the necessary human capital is not lost. In this context, it is also important to consider the fact that firms need to maintain a certain size in order to be sustainable in the future.⁴⁴ It may also be possible to outsource cross sectional units to external service providers. Non-essential services (e.g., management of firm canteens, vacation homes, etc.) should be not be part of a company's overall portfolio.⁴⁵

⁴² See Schweickart (1997), p. 8.

⁴³ See Albach (1998), p. 16.

⁴⁴ See Kohler (1994), p. 88 and Dürnhöfer (1998), p. 167.

⁴⁵ See Dürnhöfer (1998), p. 161.

4.2 Macroeconomic Management and Privatization Policy During the Transformation Process: Seven Propositions

Proposition 1 The privatization process should be implemented quickly.

As soon as the decision has been taken to initiate a deconcentration process to centralized socialist economic structures, it is crucial to also quickly launch the privatization process. The companies that emerge from such a deconcentration process can only be successful in the marketplace when they are under private ownership and management. This applies in particular to the necessary rehabilitation process. Restructuring under public sector management often remains incomplete and inconsistent, due to political-economic reasons. The rehabilitation costs that are incurred after privatization should therefore be smaller compared to the costs that would apply in case restructuring was planned and implemented by the government. All of this, of course, presupposes that the government decides to privatize unrehabilitated production facilities. Under these circumstances, a quick privatization is of the essence. Otherwise, further losses in the net value of fixed assets have to be expected.⁴⁶

A consistent reform policy should also allow bankruptcies and failures. Of course, this is particularly difficult (if not politically impossible) in the case of factory towns. Yet, inefficient production facilities cannot and should not be maintained (and therefore subsidized) for a long time without the prospect that they will eventually be successful in the marketplace. Yet, even in those cases in which the core business of a *Kombinat* needs to be closed, there may be certain parts of the old conglomerate that could perform well in a competitive market.⁴⁷

Proposition 2 Policymakers and public administration can play constructive role in facilitating a quick and successful privatization process.

Policymakers, public administrators, and the privatization agency should act quickly and consistently during privatization processes. The East German experience has demonstrated time and again that swiftness and flexibility significantly improve the probability of economic survival for the affected companies. For that very reason, the principle of "Priority of Investment" was applied to all official approval procedures in East Germany, thereby significantly expediting bureaucratic processes. Good relations between companies and the local and regional public administration is a critical success factor in this context. This also presupposes the existences of capable and decisive public managers.⁴⁸ In order to facilitate the speedy restructuring of factory towns, the necessary bureaucratic processes have to be initiated at a very early point in time. As demonstrated in some of the examples discussed in the previous section, a masterplan for the entire region may in fact be a

⁴⁶ See Dürnhöfer (1998), p. 225.

⁴⁷ See Schweickart (1997), p. 9 and Bocker (1999).

⁴⁸ See Albach (1998), p. 31 and Derlien et al. (1999), p. 37.

helpful planning device. On the national level, the necessary legal and institutional preconditions for privatization need to be put in place. This includes an allocation of clear roles and responsibilities in the privatization exercise, with transparent and explicable sales procedures.⁴⁹

Proposition 3 Open markets increase the efficiency of the restructuring process.

External competitors and investors are attracted by open markets. Both are useful for the restructuring process.

As a result of the centralized production structures that emerged as a result of socialist planning, a successful deconcentration process may not necessarily result in competitive market structures. Such structures have to be seen as a requirement for outsourced companies to develop new delivery and supply chains. Competitors accelerate this development.⁵⁰

External investors can significantly increase the speed of the transformation process since they facilitate the transfer of crucial intellectual infrastructure into the newly created company. The speed of rehabilitation is also dependent on the possibility to implement reform measures in a forceful and effective way. This applies particularly to companies under majority ownership (>50%). Albach elaborates the outstanding importance of access to the implicit know-how of market economy networks for the transformation process. Therefore, privatization by strategic (foreign) investors theoretically promises higher transaction cost efficiency. The experience in East Germany also shows that external investors, on average, (are able to) invest more than locals.⁵¹

Proposition 4 The specific form of privatization is dependent on important political premises.

Privatization procedures can be differentiated according to two basic criteria: A state-owned company can be transferred to a new owner gratis or with a price tag; and the contract of sale can be either standardized or customized. Based on these two criteria, we can develop the following ideal-types:

⁴⁹ See Brocker (1999).

⁵⁰ See Dürnhöfer (1998), p. 225.

⁵¹ See Albach (1998), p. 22, Albach (1993), p.90 and Deutsches Institut für Wirtschaftsforschung Berlin / Institut für Weltwirtschaft an der Universität Kiel / Institut für Wirtschaftsforschung Halle (1998).

		Complexity of Transfer Agreements	
		Standardized Contract	Customized Contract
Price	Gratis Transfer	Voucher-Privatization= „People's Shares“	Re-privatization
	Sale	Auction or Stock Exchange Privatization	Informal Sales Negotiations

Source: Dürnhöfer (1998), p.232.

Empirical analyses show that the specific form of privatization does not have any immediate consequences for the overall speed of the process. Each option has its advantages and disadvantages: For example, in case privatization is mediated through a stock exchange, that process does not ensure that the buyers will have sufficient financial capital to finance the necessary modernization investments. Finally, stock exchange privatization provides the government, management, and employees only with very little opportunity to influence the determinants of the eventual transformation process. Privatization through stock exchanges also pre-supposes the existence of efficient capital markets. This also applies to voucher privatization. In the case of re-privatization, those eligible to gain control over the company (in many cases the generation of grandchildren) may not have the economic competency to manage a successful transformation process. Individual negotiations, at the same time, do not feature an open competition of bidders. This opens the door to intransparent decision-making and corruption. Obviously, the choice of privatization method is a political one and is often the result of a difficult and controversial negotiation process. The advantages and disadvantages of the various privatization methods are summarized in a table in the appendix (p. 36).⁵²

Proposition 5 The government may offer financial incentives to support the transformation process. Yet, long-term subsidies should be avoided.

In order to speed up the privatization process, the government may offer financial incentives. Targeted, nonrecurring subsidies should be the norm. Such subsidies may also allow the government to attach conditions to a privatization process that may follow from political objectives (e.g., saving jobs or a minimum level of investment). The subsidy should be designed to compensate the investor for potential disadvantages related to the specific production site. Permanent subsidies should be avoided. They are not only a liability for the state budget. In the long-term, they may also inhibit the development of sustainable and market-oriented corporate

⁵² See Dürnhöfer (1998), p. 232.

strategies.⁵³

Proposition 6 In some cases, the modernization of core business facilities may have to be completed before privatization.

Certain industrial sectors are highly dependent on the existence of a strong technical and logistical infrastructure to support their highly integrated and resource intensive production cycles (e.g., the chemical sector). This is not to say that such "utilities" cannot be privatized. Yet, experience shows that such companies only become interesting for potential investors in case other companies have already invested at the same site.

The case study "Chemical Triangle" demonstrates that it may make sense under such circumstances to modernize certain segments of the former socialist conglomerate in order to support the overall restructuring process. That way, companies can concentrate on their core productive activities. Other necessary support services (e.g., pipelines, vocational education, firm canteens, etc.) can be procured from competing local service companies. This results into lower overall investment costs, since various companies can share the support service network. Since companies can concentrate on their core competencies and have to invest less into non-essential services, their competitive position in the market is strengthened.⁵⁴

This model is particularly relevant for factory towns. In most cases, it is fair to assume that newly created companies located in the formerly socialist factory towns will remain active in the same core business sectors. In case that sector promises future growth potential, it may make sense for the government to subsidize the improvement of local infrastructure to facilitate and support the modernization of economic structures. The same applies to those cases in which there is a strong degradation of the environment as a result of previous production practices. A rehabilitation of the environment often is a precondition for privatization, since private investors do not want to incur the costs of cleaning up.⁵⁵

Proposition 7 Attracting new companies is necessary for the successful completion of a restructuring process.

Even if the modernization and restructuring process of a *Kombinat* is wildly successful, it is highly unlikely that the newly competitive companies will offer the same number of jobs to the local workforce. Unemployment is a notorious feature of the transformation process. The creation of new companies and external settlers are therefore crucial just from the perspective of creating new and necessary jobs for the local economy. Yet, the diversification of local economies is also a critical

⁵³ See Schweickart (1997), p. 13 and Deutsches Institut für Wirtschaftsforschung Berlin / Institut für Weltwirtschaft an der Universität Kiel / Institut für Wirtschaftsforschung Halle (1998).

⁵⁴ See Derlien et al. (1999), p. 21.

⁵⁵ See Derlien et al. (1999), p. 8.

precondition for the sustainable growth of an entire region. In addition, increased competition among the deconcentrated companies amplifies the necessity to become more competitive. The entire production chain profits from improved competitiveness, due to lower prices for intermediate products.⁵⁶ A factory town is able to reduce its dependency on a single economic sector through diversification, and as a result protects the entire region against asymmetrical cyclical crises.

4.3 Labor Market and Social Policies and the Transformation Process: Five Propositions

The privatization of former *Kombinate* and VEB usually results into a massive loss of jobs for the local economy. In order to reduce costs and to increase productivity, investors need to be able to cut jobs. Considering the typical cost functions of the former state-owned enterprises, the creation of profitable jobs is a central challenge of the transformation process. As a result, transformation processes are almost always tied to steadily increasing unemployment rates. Public policymakers have to adopt a number of corresponding measures in order to balance the social and political consequences of that process. Only a collaborative approach that brings together all actors of the privatization process can succeed in managing the transformation process in a socially acceptable way.⁵⁷

Proposition 1 The maintenance of jobs has to be a significant guiding factor for the government in privatization negotiations with potential investors.

The restructuring and modernization of *Kombinate* usually results into massive job losses. All transformation countries have to devise a political response to this inevitable development. The government can directly influence the employment strategy of investors during the privatization negotiations. A sensible middle way needs to be devised that balances the requirements of the investor to rationalize production and to turn the company into a competitive market player, with the goal and mandate of the government to secure as many jobs as possible.

The leverage of the government in this context is the sales price. The government may lower the price and also offer investment subsidies in case the investor issues certain guarantees with regard to employment levels. In addition, the investor can also be integrated into indirect job generation mechanisms, such as "employment companies" (see below). The German government has signed many such agreements during the transformation process. In case companies have violated the agreement, they had to pay fines, or the sales price was adjusted retroactively. It is important to point out, however, that the restructuring and modernization process

⁵⁶ See Albach (1998), p. 32 and Derlien et al. (1999), p. 21.

⁵⁷ See Pohl (2000), p. 227 and Bocker (1999).

should not fail as a result of demands for unrealistic employment guarantees. The experience in East Germany shows that companies usually abide by such agreements.⁵⁸

Proposition 2 Management Buy-outs preserve jobs.

A particularly close relationship between buyer and employees exists in the case of management buy-outs (MBO). In case such an MBO is a realistic alternative, we can expect a strong interest on the part of company management to preserve jobs, at least when compared to a potential external investor. A certain sense of responsibility on the part of the old (and new) management, as well as strong loyalty on the part of the employees, are factors that are very difficult to set down in a written contract. Yet, they are important factors for a successful restructuring and modernization process. MBOs may be a preferable option for privatization since the new owners have a high degree of implicit knowledge about the specific company at hand. They know the implicit and explicit corporate structures inside-out, and they are also well aware of all the supplier and buyer relationships the company maintains. One disadvantage of MBOs in formerly socialist economies is the lack of qualification of management. Yet, this qualification only applies in cases where privatization is implemented over night, as was the case in East Germany. In other formerly socialist economies, a step-wise transformation allowed individuals to "learn on the job" about the rules of the capitalist economy.

Due to the second disadvantage, limited financial means of most managers of formerly state-owned enterprises, MBOs most apply only to small enterprises. For such small companies, there is usually also a lack of interest from external investors. MBOs are a critical factor in building a local structure of small and medium-sized enterprises (SME) – a critical contribution to building a larger and more diversified economic base for the factory towns.⁵⁹

Proposition 3 The restructuring process requires a flexible approach with regard to legal social protection clauses.

The restructuring and modernization of formerly state-owned enterprises frequently collides with social protection clauses. This applies in particular with regard to "hiring and firing" rules. In case Western-style rules had been applied to East Germany during the transformation process, it would have been almost impossible for investors to fundamentally rebuild the personnel structure. This would have undermined all restructuring efforts. A more flexible approach towards social protection is crucial to facilitate a quick and successful transformation process. The same applies to compensation rules, that have the potential to ruin a newly created company. During the restructuring process, massive layoffs can also be avoided by concessions with regard to pay levels. Due to exceptional circumstances, employers

⁵⁸ See Bocker (1999).

⁵⁹ See Albach (1998), pp. 19 and Bocker (1999).

and employees can agree to freeze the pay levels for a certain period of time. They may also agree to cut vacation time, at least temporarily. The government has to create the adequate legal framework conditions to facilitate a more flexible environment for the transformation process. Agreements between employers and employees on the level of the company can facilitate a flexible adoption of such exceptions; that way, employers also feel a certain sense of obligation to the process.⁶⁰

Proposition 4 Employment companies contribute to active labor market policy.

Publicly supported Employment and Training Companies (ETC) can play an important role in providing unemployed workers with new opportunities. In East Germany, ETCs were created as a joint exercise of employers, trade unions, and regional representatives. The participation of employers in the ETCs was usually negotiated as part of the privatization agreements drawn up between external investors, the THA and the government. The financing for the ETCs was provided through various revenue streams: The unemployment benefits of displaced workers, third party contracts (including from the public sector, as well as companies that had laid off workers), additional contributions from the federal employment agency, as well as contributions from the local and national governments). Displaced workers are not forced to work for an ETC. In contrast, they voluntarily decide to sign a work contract. (Alternatively, they can receive unemployment benefits.) ETCs are not profit-oriented companies. Their goal is to provide work and market-oriented qualification opportunities for workers displaced as a result of company transformation processes.⁶¹

Proposition 5 Give employees and trade unions a stake in the transformation process.

The East German experience demonstrates that providing those affected by reforms with a significant stake in the transformation process is a crucial precondition for the success and sustainability of the reforms. During a process of economic transformation, this may apply to the employees directly, or to those that represent their interests (i.e. trade unions). Yet, providing those affected with a stake in the process should not result in raising unrealistic expectations. It is important to clearly assess the economic situation, and to indicate the steps that have to be taken, no matter how painful they may be. The East German experience shows that employees and management are usually convinced that “their company” is quite productive and competitive – despite the fact that the new framework conditions require a complete reassessment of the net value of a company’s assets. It is crucial to raise awareness among employees and trade unions for this fundamental problem in order to receive their support for the transformation process. If that does not succeed, a demotivated work force will be the result. Under such circumstances, the top

⁶⁰ See Bocker (1999) and Jürgens et al. (1993), p. 237.

⁶¹ See Jürgens et al. (1993), p. 232, Bocker (1999) and Mayer (2000).

performers in the company will use every opportunity they get to exit. The breakdown of the transformation process may be the result.⁶²

4.4 The Important Role of Regional Planning: Three Propositions

Proposition 1 The region should be the engine of the transformation process.

Local and regional policymakers and public administrators are most familiar with the economic troubles of their region. These public elites – out of their own self-interest – have to be the main supporters and advocates of the economic restructuring and modernization process. In difficult phases of the transformation process, it should be regional policy elites and administrators that have to bring all actors to the negotiating table.

The case study "Niederlausitz" demonstrates how effective regional policies and a strong regional identity can defy conventional economic wisdom. There may also be a strong identification of the population with a local company that has provided jobs as well as goods and services for the region for decades. Such a strong regional identity and close association of the local population with specific companies can have a strong positive impact on the motivation of employees. Regional employment "pacts" can make another significant contribution to that process.⁶³ As noted above, in some cases the development of a regional masterplan may be a useful tool to sketch out the economic potential of the entire region. Such a masterplan can also be a helpful device to manage expectations.

Proposition 2 Local and regional bodies have to provide crucial social services.

In socialist planned economies, state-owned companies were frequently mandated to provide critical social services to their employees and to the public at large. It has to be part of the restructuring process to clearly delink these social services from the privatized companies. However, such a clear division between economic and social sectors does not necessarily preclude effective and innovative cooperation between a local company and the city administration. There has to be a willingness to assume responsibility on both sides. Both are jointly responsible for creating the proper framework conditions for the development of an attractive and economically successful region. Attracting new investors and promoting the diversification of the local economy are two important ingredients of that process.

⁶² See Brocker (1999).

⁶³ See Thomas (2002), p. 12.

Proposition 3 The restructuring of factory towns is in the regional as well as the national interest.

The success or failure of efforts to transform factory towns has primarily regional economic implications. As a result, local and regional policymakers and public administrators have the strongest interest in facilitating a successful restructuring and modernization process. Yet, the transformation of factory towns should not be regarded solely as a regional economic policy problem. In many cases, the *Kombinate* were the only producers of certain products for the entire nation. In case the transformation process of such a *Kombinat* breaks down, there will be considerable national consequences. Those may include higher unemployment rates, increased migration flows, or rising poverty levels. In addition, a country may all of a sudden be dependent on imports of certain products to satisfy domestic demand. As a result, the management of economic transformation should not only be the prerogative of regional policy elites. Successful economic transformation is a fundamental national interest. In particular, national policy elites have to provide the adequate legal framework for successful economic transformation. This should include, for example, clearly established property rights.

Transformation cannot be successful without broad-based societal change. Free markets presuppose free and independent individuals that are able to take independent (and also self-interested!) decisions. The term speaks for itself: State-owned enterprises are owned by the state. As a result, the state has to play a critical role during the privatization and restructuring process.⁶⁴

⁶⁴ See Schweickart (1997), p. 10.

5 Conclusions

Kombinate have had a strong influence on regional economic development in socialist planned economies such as the GDR. In some cases, the creation of a *Kombinat* was the starting point for regional development – as was the case in Eisenhüttenstadt or in the West German factory town Wolfsburg.⁶⁵ Under such circumstances, city and industrial location are one and the same. Even though we have included a case study of Western Germany, it should be clear that factory towns are a typical phenomenon of planned economies. Within the Comecon group, such factory towns were supposed to generate significant economies of scale by centralizing the production in one geographical location. With the introduction of a free market system, however, factory towns face a wide range of fundamental problems. The restructuring and modernization process is particularly difficult and politically sensitive. In some cases, the economic future of an entire region depends on the successful implementation of a modernization and restructuring process. Yet, the same rules apply to the transformation process of factory towns as to all other formerly state-owned enterprises.

Early on, local policy elites have to become engaged in the transformation process in order to provide leadership and support. The integration of all stakeholders in the development of a regional masterplan can facilitate coordinated action and may nurture strong regional identities. The development of a masterplan also provides an opportunity to find out whether it makes sense that the local administration should facilitate the transformation process by financing the modernization of certain parts of the industrial infrastructure to attract investors. The region itself should diversify its economy by attracting new companies for a settlement. This way, the one-sided dependency on the one former *Kombinat* and its sectoral crises can be reduced.

Economic restructuring and modernization processes are complex. There are no panaceas. Each case has to be dealt with through a customized package of reforms. A transparent and honest stock-taking effort should always be the start of such a transformation process. That stock-taking effort may be painful both for management as well as employees. However, it is a crucial precondition for the development of a successful restructuring concept. In addition, the stock-taking effort in conjunction with the development of a restructuring plan documents for all those involved what the necessary reform steps will look like, and what they will mean. The concentration on the core business activities has to form the center of the rehabilitation plan. Non-essential business activities could be regrouped in new companies that could serve as suppliers for the core business. This way, they can diversify their business activities and find other customers. Social services have to

65 Wolfsburg – a city of roughly 125.000 – is home of the multinational Volkswagen AG. In 1938, the city of Wolfsburg was founded as the location for the production of the “true Volkswagen” (KdF-Wagen) by the Nazi regime. The idea was to design and produce a car German workers would be able to afford. Since then, the fate of the city and the company have been inexorably intertwined. The company currently employs 50.000 people.

be provided by the public sector or other parapublic institutions; they cannot remain in the portfolio of privatized companies.

While the East German *Kombinate* and state-owned companies were subjected to a probably unique process of “over-night restructuring,” the implementation of that process offers much food for thought and perhaps some potential for replication elsewhere. For Germany, there probably was no alternative to this rather rapid transformation process – mostly for domestic political reasons. Other countries may benefit from the German experience in order to find their specific way of restructuring their factory towns.

A.B.

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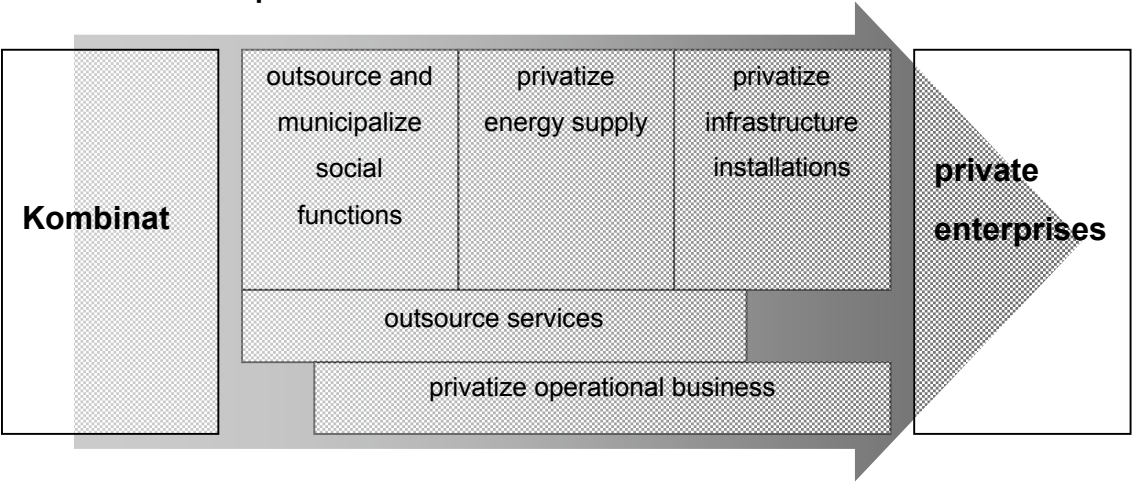
7 Annexes

Scheme 1: Taxonomy of privatization procedures

	Voucher	Public offering (stock exchange)	Auction	Reprivatization	Informal negotiations
type of contract	standard	standard	standard	individual	individual
transparency of procedure	high	High	high	medium	low
speed of privatization	lower	Lower	fast	open	open (MBO faster than with an external investor)
costs of award procedure	high	High	medium	open	low
spread of proprietary rights	yes	Yes	no	no	no
management and proprietary rights diverge	yes	Yes	open	open	open
purchase price	zero	High	high	zero	medium
competence of new owner	low	Low	high	open	open
financial resources of new owner	low	Low	high	open	open
criteria for award	nationality, costs of restructuring	costs of restructuring	purchase price	legal claim	concept, competence, financial resources, purchase price

Source: Dürnhöfer (1998), p. 249.

Scheme 2: Order of privatization



Source: Derlien et al. (1999), p.8